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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 63

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CLAY B. BROWN AND DOROTHY E. BROWN, DONALD L. BROWN AND INGRID R. BROWN, CHARLES WILLIAM BOOTH AND NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENTS

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BRIEF FOR THE RESPONDENTS

INTRODUCTION

The Respondents hereby adopt the portions of the Petitioner's brief relating to Opinions Below, Jurisdiction and Statute Involved.

QUESTION PRESENTED

Whether the following transfer complies with the sale or exchange prerequisite for long-term capital gain:

> Stockholder S transfers all the stock of Corporation X to Corporation P for an agreed-upon fixed price payable by P over a period of years where: (i) the liability of P to pay the fixed price is limited to income generated by the underlying assets (and proceeds from the disposition thereof), and (ii) P makes no down payment other than from the underlying assets.

or should all payments received by S (in excess of S's basis for the stock) be taxed as ordinary income.

STATEMENT

The pertinency of the various facts has shifted as the theory of the Commissioner has shifted. In the Tax Court, the Commissioner contended the transaction was a sham because of an alleged secret understanding between the taxpayers and the Institute whereunder the taxpayers could artifically trigger a default thereby permitting them to recapture the property at any time (Tr. 59). Because of this sham assertion, the Tax Court set forth the facts in minute detail. In the Circuit Court, the Commissioner abandoned the sham contention but claimed, among other things, that taxpayers, as a practical matter, could recapture the assets. The Circuit Court adopted the detailed findings of the Tax Court in affirming the decision below.

In his brief to this Court, the Commissioner grounds his denial of capital gain upon a theory of "transfer with a retained income interest" (Br. 2). This theory is based entirely upon the lack of down payment from independent sources and lack of personal liability on the part of the Institute to pay the purchase price, thereby making payment of the purchase price dependent upon the future income yield from the property and upon future changes in value.

Under the Commissioner's present theory, many of the details set forth in the extensive Tax Court findings are unimportant, and the pertinent facts may be simply stated. In the following statement and the remainder of the brief, Petitioner is referred to as the "Commissioner," Respondents are referred to as the "taxpayers," and the California Institute for Cancer Research is referred to as the "Institute":

1. Taxpayers transferred all of the outstanding capital stock of Clay Brown & Company and $125,000 principal amount of notes to the Institute in accordance with the provisions of the Basic Agreement dated February 4, 1953 (Exhibit 32-FF, Tr. 197), and in exchange therefor, the Institute issued its promissory note for $1,300,000 (Tr. 39).

2. The Institute made no down payment, and the liability of the Institute to pay the note was limited to the income generated by the underlying corporate assets and proceeds from the disposition thereof. As security for the note, the taxpayers received a deed of trust and chattel mortgage covering the fixed assets. The Basic Agreement spelled out the mechanics whereby the Institute would de-

rive income from the underlying assets for payment on the note. Such mechanics consisted of the following (Tr. 37-44):

(i) The Institute liquidated Clay Brown & Company and took over all the Clay Brown & Company assets subject to the liabilities.

(ii) The Institute leased the fixed assets to Fortuna Sawmills, Inc., for a 5-year term. The lease required Fortuna Sawmills, Inc. to pay rental in the amount of 80% of the net profit before taxes realized by Fortuna Sawmills, Inc.

(iii) The Institute paid upon the note 90% of all rental received from Fortuna Sawmills, Inc.

3. Clay Brown, one of the taxpayers, managed Fortuna Sawmills, Inc. under a management contract until he resigned on October 31, 1954 (Tr. 44, 48). The taxpayers did not own any stock in Fortuna Sawmills, Inc. (Tr. 42).

4. Due to adverse economic factors, the mill was shut down in June, 1957. The lease expired on January 31, 1958 (Tr. 50). Later in 1958, the Institute sold the mill properties to the Highway Department of the State of California in lieu of condemnation. Pursuant to a subsequent agreement between the parties, the Institute paid to the taxpayers 90% of the net proceeds realized by the Institute from the sale of the mill properties to the California Highway Department (Tr. 56).

5. The total amount received by the taxpayers on the note from the Institute was $936,131, including the 90% of the net proceeds from the sale of the mill properties to the California Highway Department Tr. 56).

6. In regard to determination of the purchase price, the Tax Court found that: (i) the price was the result of real negotiating (Tr. 64); (ii) the price was arrived at in an arms-length transaction (Tr. 67); (iii) the price was within a reasonable range in the light of the earnings history of the corporation and the adjusted net worth of the corporate assets (Tr. 64); and (iv) the primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been paid which would then permit the Institute to convert the property into money for use in cancer research (Tr. 36).

All Section references are references to the Internal Revenue Code of 1954 (26 U.S.C., 1958 Ed.), as amended, unless otherwise specified.

SUMMARY OF ARGUMENT

I

Since the taxpayers converted their Clay Brown & Company stock and notes into $936,131, there was a conversion of capital investment if the stock and notes were worth that amount when transferred to the Institute on February 4, 1953. The Tax Court found the purchase price was a result of real negotiating, and the Institute was properly motivated through a desire to obtain funds for cancer research. Applying the approach outlined in Revenue Ruling 59-60 for valuing the shares of stock of closely-held corporations for estate and gift tax purposes, the Clay Brown & Company stock had a value of more than $1,300,000.

II

Contrary to the assertions of the Commissioner, there are good reasons why owners of a closely-held corporation benefit from the sale of the stock at a price not in excess of its present value even though the purchasers' obligation is limited to the underlying assets.

III

At first blush, the instant transaction may have appearances of a tax avoidance scheme. Analysis of the transaction changes the complexion. The tax benefits claimed for the instant transaction are no different than benefits sought in many corporate buyouts. Minimum achievement in a corporate buyout should produce 48¢ after taxes for payment upon the purchase price per each dollar generated by the underlying assets (assuming a 52% corporate tax rate). The mechanics of the instant transaction were designed to produce 72¢. Payment of the purchase price with dollars containing substantially more than 48¢ may be accomplished in transactions not involving tax-exempt institutions. Accomplishment of the goal is a manifestation of the basic tax principle that every purchaser receives a cost basis which he is entitled to recoup some way at some time.

IV

As long as Revenue Ruling 58-353 represents the law of the land, there is no basis for denying capital gain where the purchase price is dependent upon income generated by the transferred property. The patent transfer cases approved in this Revenue Ruling are classic examples of capital gain treatment accorded payments completely dependent upon future income generated by the

property transferred. Not only are the patent payments reportable by the transferor as capital gain, but the transferee pays no taxes thereon, being able to deduct the payments in full as depreciation.

V, VI

Interrelated provisions of the Code sanction a standard plan for corporate buyouts where payment of the purchase price is dependent upon income generated by the underlying corporate assets. If the instant transaction had been accomplished under the standard plan (which contains many features similar to the instant transaction), the tax consequences at the corporate level would have approximated those of the instant transaction.

VII

A scalpel touch has been applied by Congress to the sensitive tax area here involved through the enactment of Section 1245 in the Revenue Act of 1962. Applicability of the depreciation recapture provisions of Section 1245 is triggered by the liquidating distribution of the acquired corporation, and presents a deterrent to transactions of the instant type as well as transactions under the standard plan.

VIII

Anomalies and complications encountered by the Commissioner in his argument result from features peculiar to the simplified version used as the basis for his argument,—the owner of a dividend-paying, marketable, minority interest in a widely-held corporation who transfers his stock for the right to have the dividends remit-

ted to him. Under the Commissioner's supposition, only 14¢ remains after taxes out of each dollar generated by the underlying assets. Naturally, the transaction lacks economic sense. However, the Commissioner's simplified version has no relationship to the actual facts whereunder the taxpayers sold all the stock in a closely-held corporation.

IX

A possibility that the taxpayers would receive *less* than the agreed-upon price for the Clay Brown & Company stock was the only consequence which could evolve from the lack of down payment and the limitation of the Institute's liability. Yet, such lack of down payment and limitation of liability constitutes the sole basis for the Commissioner's "transfer with income reserved" theory. A possibility that the taxpayers might receive *less* than the agreed-upon price for the stock does not militate against (much less negate) the fact that the taxpayers converted the stock into the amounts actually received. It would be different if the taxpayers received, or could receive, payments substantially exceeding the value of the stock at the time of transfer.

X

Within the last year, Congress has on two occasions expressed its intent concerning capital gain qualification for payments dependent upon future income, once through the addition of Section 483 to the Code (the interest imputation provision), and once by refusal to change the law in the manner requested by the Secretary of the Treasury. A provision in Section 483 would

be unnecessary if the full amount of payments dependent upon future income constituted "transfers with income reserved" as claimed by the Commissioner.

In a statement before the Committee on Ways and Means in the House of Representatives, the Secretary of the Treasury proposed that payments on the sale of capital assets contingent on future income be denied capital gain recognition. He illustrated the status of the present law and the desired change through an example which closely parallels the instant transaction and contains all the adverse features cited by the Commissioner. The Secretary did not say there was an ambiguity concerning the law illustrated by his example, but unequivocally stated capital gain would be accorded the transferor under present law. While Congress adopted the interest imputation provision (Section 483) proposed by the Secretary of the Treasury in the same statement, Congress declined to deny capital gain treatment for deferred payments contingent on future income.

XI

The Commissioner recognizes that the conclusion drawn by him from the oil, gas and mineral cases is inconsistent with recognition of capital gain for patent transfers under Revenue Ruling 58-353. Refusal of Congress to change the law relating to patent transfers puts the Congressional stamp of approval on patent transfers.

XII

Section 1239 recognizes that capital gain should be allowed upon the transfer of a property by an in-

dividual to a corporation in which he owns 80% of the stock. Such transactions are subjected to less interplay of economic forces than the instant one. Yet, the Courts permit capital gain treatment in Section 1239 transactions. Only the portion of the purchase price which may be found excessive is taxed as ordinary income.

XIII

For every transaction of the instant type, there are many transactions utilizing the standard plan whereunder payment of the purchase price is dependent upon income generated by the acquired assets. The Commissioner's position has equal impact upon these transactions. Such purchases, sometimes referred to as "bootstrap" purchases, have been a primary method in the past whereby "have-nots" become "haves." Adoption of the Commissioner's position would preclude such purchases and restrict to those already possessing financial affluence the ability to assure capital gain treatment to sellers.

Congress is aware of bootstrap purchases and their ramifications. Ground rules for such purchases have been affected by the adoption of Section 1245 (depreciation recapture provision) and Section 483 (interest imputation provision). These amendments, coupled with a refusal to deny capital gain treatment for deferred payments dependent upon future income, indicate an unwillingness on the part of Congress to outlaw bootstrap purchases. Rather, Congress has taken the approach of keeping such purchases within bounds through a change in the ground rules.

XIV

The Commissioner's theory is inconsistent with the position taken by him in cases denying a rental deduction to the lessee corporation. If the selling stockholder has really made a transfer with income reserved, the reserved income cannot be taxed to the lessee corporations or anyone else. Yet, as pointed out in the Commissioner's brief, he has met with some success in disallowing rental deductions to the lessee corporations.

Furthermore, if the Commissioner's theory is sustained, a remand to the Tax Court would be required for determination of the depreciation allowable to the taxpayers. The Commissioner's failure to have presented any such matters for consideration by the trial court indicates that his position before this Court is upon a completely different theory.

ARGUMENT

I

The purchase price receivable for the Clay Brown & Company stock was negotiated through arms length bargaining and did not exceed the value of the stock at the time of the sale.

"Conversion of capital investment" is the prime prerequisite for capital gain long recognized by this Court.[1] The Commissioner concedes that:

> (i) Taxpayers transferred their 32,000 shares of Clay Brown & Company stock and $125,000 principal amount of notes to the Institute in accord-

[1] *Burnet* v. *Harmel*, 287 U.S. 103, 106 (1932); *Corn Products Refining Company* v. *Commissioner*, 350 U.S. 46, 52 (1955).

ance with the provisions of the Basic Agreement dated February 4, 1953, and in exchange therefor, the Institute issued its promissory note for $1,300,000 payable to the taxpayers in the manner provided in the note and in the Basic Agreement; and.

(ii) The Institute made payments aggregating $936,131 on the promissory note, and such $936,131 is all the taxpayers have ever received for their stock and the $125,000 in notes.

The net effect of (i) and (ii) is that the stock and notes were converted into $936,131. This constitutes a conversion of capital investment in pure form provided the Clay Brown & Company stock and notes were worth $936,131 at the time of transfer on February 4, 1953.[2]

Ordinarily, when the consideration payable for property is determined through arms-length negotiations, the consideration represents the value of the property at the time of transfer, — the amount of the capital investment. The Tax Court made the following findings which the Commissioner has never questioned:

"The price . . . was the result of real negotiating." (Tr. 64).

"The finally agreed price was arrived at in an arms-length transaction . . ." (Tr. 67).

The price was ". . . within a reasonable range in the light of the earnings history of the corpora-

[2] Taxpayers are not making any point concerning the difference between the $936,131 actually received, and the $1,300,000 purchase price so far as value at the time of transfer is concerned. As hereinafter related, the stock and notes were worth at least $1,300,000 so the difference between the two figures is immaterial.

tion and the adjusted net worth of the corporate assets." (Tr. 64).

"Petitioners by the transaction here involved parted with their equitable ownership of the assets when they transferred their stock to the Institute and became the creditors of the Institute with mortgages and a management contract as security for payment of the purchase price of the stock." (Tr. 60).

"The primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money for use in cancer research." (Tr. 36).

The above findings of the Tax Court were emphasized by the Circuit Court in its affirmance of the Tax Court decision.[3]

Despite his acceptance of the findings related in the preceding paragraph, the Commissioner makes an oblique attack thereon by questioning the significance of the findings through a claim that any bargaining is "economically meaningless" (Br. 36) where the obligation of the transferee to pay the purchase price is limited to in-

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[3] "There was considerable bargaining, at arms length, and a price was agreed upon that was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of its assets." (Tr. 292).

". . . there was a change of economic benefits in the transaction." (Tr. 294).

". . . the primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money for use in cancer research." (Tr. 294).

come generated by the underlying assets with no down payment from independent sources. Under such circumstances, the Commissioner claims the purchase price "must be substantially greater than the present value of the stock or the transferor is a fool . . ." (Br. 56).

The primary factors for determining stock values are the actual value of the underlying corporate assets less liabilities, and the earnings record of the corporation. The starting point in determining the net value of the underlying assets of Clay Brown & Company is the balance sheet of the corporation at January 31, 1953 set forth in the Tax Court findings (Tr. 22). The stockholder equity shown on this balance sheet, plus the $125,000 in notes, aggregated $619,457.[4] Of this amount, $448,471 constituted retained earnings which had been subjected to corporate tax. While the Commissioner often refers to the avoidance of corporate tax under the instant transaction, he mentions nothing concerning the propriety of taxing as ordinary income all sums received by the taxpayers from the Institute (in excess of their basis for the stock and notes) when $448,471 of such amount represents retained earnings of Clay Brown & Company. The $619,457 of stockholder equity shown on the January 31, 1953 balance sheet reflects book values, not actual values. Substitution of appraised values for book values, increases the

[4] The $619,457 is the aggregate of the following contained in the January 31, 1953 balance sheet set forth in the Tax Court findings (Tr. 22): Earned surplus—$448,471.63. Paid in or Capital Surplus—$13,986, Capital Stock—$32,000 and the $125,000 in notes contained in the bonds, notes and mortgages figure of $529,407.60. The $125,000 in notes is set forth separately on the audited financial statement of January 31, 1953 (Tr. 281).

net worth to at least $1,100,000.[5] Therefore, based on the actual value of the underlying assets at the time of the stock transfer, the amount of the taxpayers' capital investment was not less than $1,100,000. This exceeded the $936,131 aggregate amount received by the taxpayers from the Institute as the only consideration for their stock and the notes.

In Revenue Ruling 59-60[6] issued by the Commissioner to outline the approach, methods and factors to be considered in valuing shares of capital stock of closely-held corporations for estate and gift tax purposes, primary consideration is accorded earnings when valuing stocks of companies which sell products or services to the public. A reading of cases[7] involving the de-

[5] The pro forma balance sheet using appraised values instead of book values was enclosed to the Institute under letter dated December 23, 1952 from an officer of Clay Brown & Company. The essence of this letter is related in the Tax Court findings (Tr. 30). The net worth based on appraised values was $1,050,000 before the supplemental appraisal which showed increased values. Also, as found by the Tax Court (Tr. 48), Fortuna Sawmills, Inc. harvested over 20,000,000 feet from the timber interest assigned to it by the Institute which the Institute had received upon the liquidation of Clay Brown & Company. This was substantially more than the 15,000,000 feet estimated on the balance sheet showing adjusted values for assets in determining the before-mentioned $1,050,000 net worth. Also, the amount per 1000 board feet used in determining adjusted values was $8.20 per thousand board feet whereas an independent appraisal as of May 1, 1952 showed a value of $9.00 per thousand board feet. This excess in timber value was $57,000. Such $57,000 plus the $1,050,000 exceeds the $1,100,000, not counting the additional values shown by the supplemental appraisals.

[6] 1959-1 Cum. Bull. 237.

[7] An earnings summary of Clay Brown & Company discloses average annual earnings of $339,000.00 prior to the subject sale (Tr. 35). Capitalization of these earnings at 20% to arrive at stock value equals $1,695,000.00. Neither the Commissioner nor any Court has attempted to capitalize earnings to arrive at stock value by use of a capitalization rate higher than 20%. *Laird et al,*

termination of stock values based on a capitalization of earnings approach makes it clear that the Commissioner would assert (and probably sustain) a value of more than $1,175,000 for the Clay Brown & Company stock ($1,300,000 less the $125,000 promissory notes) if he were valuing same on February 4, 1953 for estate or gift tax purposes. A value appropriate for gift and estate tax purposes is not excessive for purposes of the "conversion of capital investment" prerequisite for capital gain.

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38 B.T.A. 926 (1938) (Commissioner attacks the capitalization rate approximating 12% utilized by the petitioners as being too high.); *Wishon* v. *Anglim*, 42 F. Supp. 359 (D.C.N.D. Cal. 1941) (Court utilizes 6% capitalization rate); *Estate of L. J. Burda*, 2 T.C.M. 497 (1943) (Commissioner utilizes 10% capitalization rate); *Estate of Lizzie F. Olney*, 5 T.C.M. 503 (1946) (Commissioner utilizes capitalization rate approximating 9%); *Estate of William S. Cherry*, 5 T.C.M. 495 (1947) (Commissioner utilizes 10% capitalization rate); *Estate of J. B. Davis*, 5 T.C.M. 1064 (1947) (Court upholds Commissioner's determination by utilizing 14½% capitalization rate); *Bader* v. *U. S.*, 172 F. Supp. 833 (D.C.S.D. Ill. 1959) (The Commissioner asserts a capitalization rate approximating 7%). In *Kline* v. *C.I.R.*, 130 F.2d 742 (3d Cir. 1942) the court states (at 745):

> "The value of a stock is put by many conservative authorities at 10 times its annual earnings. Other authorities set the value of a stock at 12 to 15 times its annual earnings. Some stock, considered sound, today sell at 25 times their annual earnings."

In *Florence M. Harrison*, 17 T.C.M. 776 (1958) the court preceded the above quote from *Kline* v. *C.I.R.* with the following comment (at 779):

> "A method frequently adopted by the Courts, confronted with the problem of evaluation of stock, is to capitalize the earning rates varying from 6% to approximately 10%."

Capitalization of average annual earnings of Clay Brown & Company at 6% to arrive at stock value would generate a value of $5,550,000.00. Capitalization of such earnings at 10% generates a value of $3,390,000.00. If such earnings were capitalized at the highest rate (approximately 15%) utilized by the Commissioner or any court, the value of the stock of Clay Brown & Company would approximate $2,200,000.00. To repeat, capitalization of Clay Brown & Company earnings at 20% to arrive at stock value generates a value of $1,675,000.00.

II

An owner of all the stock in a closely-held corporation need not be a fool to sell his stock in a transaction whereunder payment of the purchase price is dependent upon future income generated by the underlying assets, although motivation for such sale may be lacking in the case of the stockholder depicted by the Commissioner in his simplified version of the transaction.

Since the taxpayers *did* transfer the Clay Brown & Company stock and notes for the right to receive an amount not in excess of their value at the time of transfer on February 4, 1953, the taxpayers were fools (the only alternative offered by the Commissioner), or there is some fallacy in the Commissioner's thesis that a stockholder has nothing to gain from a sale to a purchaser whose liability is limited to the underlying assets.

The starting point is whether a sale on a deferred basis has attraction for a stockholder *irrespective* of how payment of the deferred purchase price will be funded. If a sale on a deferred basis has little attraction to a stockholder under any circumstances, no amount of financial responsibility on the part of the purchaser will cure the lack. For example, a deferred-payment sale would not offer much to "A" in the Commissioner's supposition (Br. 30-31) since A's stock is traded over-the-counter, and A can sell his stock for all cash any time he desires. On the other hand, if a sale of stock on a deferred basis has attraction to a stockholder, should the stockholder reject the benefits of the sale merely because the purchaser is unable to furnish

personal liability or a substantial down payment? The Commissioner is letting the tail wag the dog. The only adverse consequence which can evolve from the purchaser's limitation of liability is the possibility the seller may not receive all of the purchase price. Where the seller is entitled to receive payment in full before the purchaser derives any substantial benefits, the risk is not as severe as the Commissioner infers.

It is really a question of emphasis. The Commissioner throws the spotlight on the lack of down payment and limitation of liability (Br. 31). With the spotlight thus focused, the Commissioner asks who in his right mind would sell under such circumstances, and supplements his query with a supposed set of facts under which the owner of a marketable security would have nothing to gain even upon a deferred sale to a person furnishing personal liability. Naturally, the stockholder, who has nothing particularly to gain from a deferred sale under any circumstances, would not sell with the spotlight focused on the lack of down payment and limited liability. A change of situation and emphasis produces an entirely different picture. There are many advantages (both tax and non-tax) to be derived from the sale of stock in a closely-held corporation upon a deferred-payment basis.[6] With the spotlight focused on

[6] A number of the advantages are enumerated in the brochure presented by the Institute to Clay Brown (Tr. 172-173). The Commissioner's brief sets forth a partial quotation from the brochure. The advantages quoted by the Commissioner in his brief are only the income tax advantages. He deletes from his quotation the other advantages recited in the brochure which are: the elimination of the risk that after the death of the owners, the business may be subjected to a forced sale or liquidation

these advantages, should a purchase offer be rejected because the one making the offer cannot, for good cause, become personally liable to pay the purchase price or make any down payment from independent sources?

III.

The tax benefits claimed for the instant transaction are no different than the tax benefits sought in many corporate buyouts.

The tenor of the Commissioner's brief is expressed in the following quotation from his introduction (Br. 26):

> "That there is *something* wrong with a transaction for which such extraordinary tax benefits are claimed seems apparent. The difficulty lies in identifying precisely what is wrong . . ."

Are the tax benefits claimed for the instant transaction really "extraordinary," or are the same benefits sought in many corporate buyouts not involving tax-exempt institutions?

Every business is expected to pay for itself. One manifestation of this expectation is a corporate buyout whereunder the purchase price is paid from income generated by the underlying assets of the acquired corpor-

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at possible disastrous loss to the families; avoidance of the risk of the buiness being ruined by incompetent management if sold to others for payment on an installment basis; and protection of the family from estate and inheritance taxes. Under the contentions made by the Commissioner before the Tax Court, it was not considered material why the taxpayers sold their stock to the Institute. This question was not asked Clay Brown either by counsel for the Commissioner or counsel for the taxpayers. The fact remains that they *did* sell for a price representing the value of the stock and notes at the time of transfer.

ation. If each dollar generated by the underlying assets for payment upon the purchase price is taxed at a corporate rate of 52%, only 48¢ remains after taxes out of each generated dollar. It takes longer to pay the purchase price with 48-cent dollars than with 100-cent dollars. An obvious goal is payment of the purchase price with dollars containing as many cents in excess of 48 as possible. The mechanics specified in the Basic Agreement (liquidation of Clay Brown & Company into the Institute and lease of the assets to Fortuna Sawmills, Inc.) were designed to produce 72-cent dollars for payment upon the purchase price out of each dollar generated by the underlying assets.[9]

Payment of the purchase price with dollars containing substantially more than 48 cents after taxes is not the dream of an alchemist. The plausibility of attaining the goal stems from the fundamental proposition that every purchaser receives a tax basis for property equal to his cost which he is entitled to recoup in some way at some time without payment of tax upon the recoupment. One way of recouping basis is through depreciation. Depreciation is an income tax deduction which does not require a cash outlay. For example, if a corporation has $100,000.00 of income and $50,000.00 of depreciation, the corporation has $50,000.00 of net taxable income ($100,000.00 less $50,000.00) subject to a $26,000.00 tax (52% of $50,000.00) leaving $74,000.00 available for expenditure upon the purchase

[9] Fortuna Sawmills, Inc. retained 20c out of each dollar generated by its operations and paid 80c to the Institute. The Institute retained 18c (90% of the 80c) and paid the remaining 72c upon the note.

price, i.e.—74-cent dollars as contrasted to 48-cent dollars.[10]

Where payment of the purchase price for depreciable property coincides exactly with the economic life of the acquired property, the exact amount reportable as capital gain by the transferor is deductible by the transferee, with the result that no tax is incurred by the transferee on the amounts paid to the transferor. Classic examples of transactions of this type are reviewed under the next heading. The problem is more difficult when the seller is not willing to defer receipt of the purchase price over the remaining useful life of the property, but desires payment from income generated by the underlying assets as quickly as possible. The instant transaction falls within this category, as do corporate buyouts under the standard plan discussed under Point V below.

While any corporate buyout should produce 48¢ for payment upon the purchase price out of each dollar generated by the underlying assets, a little misguidance can result in 14-cent dollars. For example, A purchases all of the stock of X Corporation from S and pays the purchase price with after-tax net income extracted from X Corporation as dividends. The 48¢ of X Corporation income remaining after a 52% corporate tax is subject to a 70% individual tax rate when received by A as dividends. The 48¢ less the 70%

[10] The technical term for the $74,000 is "cash flow" or "cash income". Cash flow is net income after taxes plus deductions not requiring cash outlays such as depreciation and depletion. The references in this brief to income generated by the underlying assets means cash flow rather than net income after depreciation.

individual tax leaves but 14.4¢ after taxes for payment by A upon the purchase price. As pointed out later, the "simplified version" of the transaction used by the Commissioner as the basis for his argument is a transaction falling within this 14-cent dollar category.

Admittedly, the tax benefits sought for the instant transaction under the Basic Agreement were: (i) capital gain treatment for the payments received by the taxpayers on the $1,300,000 note evidencing the consideration payable for the Clay Brown and Company stock; and (ii) payment of the purchase price for the Clay Brown & Company stock with 72¢ out of each dollar generated by the underlying corporate assets. A showing that these tax benefits are sought in ordinary transactions sanctioned by the Internal Revenue Code should serve to bring the transaction into the proper perspective which prompted the decisions of the Tax Court and the Circuit Court below, and prompted capital gain recognition by all other courts which have reviewed similar transactions.[11]

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[11] *Union Bank* v. *United States*, 285 F.2d 126 (Ct. Cls. 1961); *Anderson Dairy, Inc.*, 39 T.C. 1027 (1963); *Royal Farms Dairy Co.*, 40 T. C. 172 (1963); *Singer*, 22 T.C.M. 759 (1963); *Isis Windows, Inc.*, 22 T.C.M. 837 (1963); *Stahl*, 22 T.C.M. 996 (1963).

IV

Patent transfers covered by Revenue Ruling 58-353 present classic examples of an exact correlation between recoupment of cost basis and payment upon the purchase price reportable by the transferor as capital gain and classic examples of consideration dependent upon future income. A Code provision sanctions such tax consequences even though the transferee is a corporation in which the transferor owns 80% of the stock.

Capital gain treatment for the following transaction is confirmed by Revenue Ruling 58-353[12] under the general capital gain provision of the Code here involved.[13] S, owner of a patent which he purchased from the inventor, grants Corporation X an exclusive license to use, manufacture and sell under the patent during the remaining fifteen year life of the patent. In consideration of such transfer, Corporation X agrees to pay S royalties equal to a specified percentage of the net profit realized by X from exploitation of the patent. The agreement permits S to recapture the patent and terminate the rights of Corporation X upon failure of X to pay specified minimum amounts.

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[12] 1958-2 Cum. Bull. 408.

[13] Section 1235 applies to the sale or exchange of patents by the inventor or any other individual who has acquired his interest in the patent for consideration paid to the inventor prior to actual reduction to practice. The situation depicted in the supposition is beyond the scope of Section 1235 because S was not the inventor and did not obtain his interest through consideration paid to the inventor prior to the actual reduction to practice. The cases covered by Revenue Ruling 58-353 are in this latter category of situations beyond the scope of Section 1235. As indicated by the cases cited in the Revenue Ruling, Section 1235 is not deemed exclusive and failure to come within Section 1235 does not preclude capital gain recognition under the general capital gain provisions.

Not covered by Revenue Ruling 58-353, but equally important to the overall transaction, is the right of Corporation X to deduct as depreciation the full amount of the royalties paid to S. Such right is confirmed by the Commissioner's published acquiescence in the case of *Associated Patentees, Inc.*, 4 T. C. 979 (1945).[14] Ability of Corporation X to deduct the royalties from ordinary income as and when paid to S means that the royalties paid to S are not subjected to X's corporate income tax. This is not tax avoidance, but is a manifestation of the axiom that every purchaser receives a basis for property equal to the purchase price which he is entitled to recoup tax free in some way, at some time. Here, the tax recoupment of basis through depreciation deductions coincides exactly with payments upon the purchase price.

Not only do the patent transfers covered by Revenue Ruling 58-353 represent classic examples of an exact correlation between recoupment of cost basis and payment upon the purchase price, but such transfers are classic examples of consideration dependent upon future income of the property transferred. The consideration for such transfers is *completely* dependent upon future income because the amount of the consideration is measured by the future income derived by the transferee from the use of the patent. As long as Revenue Ruling 58-353 represents the law of the land, there is no ground for the Commissioner's contention that cap-

[14] In 1946-1 Cum. Bull. 1, the Commissioner published his acquiescence in result only to *Associated Patentees, Inc.* The Commissioner in 1959-2 Cum. Bull. 3 withdrew his acquiescence in result only and substituted his acquiescence.

ital gain recognition should be denied the taxpayers because payment of the consideration for the Clay Brown & Company stock was dependent upon future income derived from the underlying corporate assets. As related under point X, a refusal by Congress to adopt a proposal of the Secretary of the Treasury reversing the law of Revenue Ruling 58-353 unequivocally confirms that the law set forth in Revenue Ruling 58-353 is in accord with Congressional intent.

The cases cited in Revenue Ruling 58-353 accord capital gain treatment to S even though S owns up to 80% of the stock of X Corporation. Revenue Ruling 58-353 refers to Section 1239 which denies capital gain treatment upon the sale of depreciable property to a corporation in which the transferor owns more than 80% of the stock. By denying capital gain treatment upon a sale to an 81% owned corporation, Section 1239 recognizes that capital gain is allowable where the transferor's stock interest in the transferee is less than 80%.[15] Ownership of stock in the transferee is a substantial tax benefit. The taxpayers did not own any stock in the Institute or in Fortuna Sawmills, Inc.

Ability of the transferor to own up to 80% of the stock of the transferee negates the Commissioner's suggestion that an independent expenditure of effort and money by the transferee in patent cases may be a distinguishing feature. The sawmill and other activities of Clay Brown & Company could not run themselves after the transfer of the stock to the Institute. True,

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[15] Section 1239 applies to all depreciable property, not patents alone.

Clay Brown was the manager of Fortuna Sawmills, Inc. until his resignation on October 31, 1954. However, it is not uncommon for a controlling stockholder to install himself as director and chief executive officer of his 80%-owned corporation. The control which Clay Brown could exercise over Fortuna Sawmills, Inc., through his management contract was mild in comparison with control exercisable by an 80%-stockholder.

V

There is a standard plan for corporate buyouts where payment of the purchase price is dependent upon income generated by the underlying corporate assets. This plan, sanctioned by interrelated provisions of the Code, has features and tax consequences identical to the instant transaction.

Stockholder S owns all the stock of X Corporation which S believes is worth at least $1,300,000. P desires to purchase Corporation X, but has nothing like $1,300,000. Due to P's limited resources, payment of the purchase price will be dependent upon income generated by X's assets. S is willing to entertain a purchase offer if the business can pay off the purchase price over a reasonable period of time. This is not an unusual situation. A typical example is the industrious employee who desires to buy out his employer.

Only 14-cent dollars will be available to P from income generated by the underlying assets if P purchases the X stock and pays the purchase price from after-tax income of X distributed to P as dividends.[16] There

[16] As related supra, the 48c of X Corporation income remaining after 52% corporate taxes is subject to a 70% individual tax

is, however, a standard corporate buyout plan which not only eliminates the necessity for dividend extraction to pay the purchase price but increases the cash flow generated by the underlying assets over the cash flow available to X Corporation. This standard plan is outlined below:

1. P forms new corporation, Y. Y Corporation (not P) purchases the X Corporation stock from S. Y Corporation obligates itself to pay the agreed-upon price of $1,300,000 for the X stock. The obligation of Y Corporation to pay the purchase price for the X stock is evidenced by Y's promissory note payable to S over a period of years.

2. X Corporation is immediately liquidated into Y. Corporation with Y taking over all of the assets and liabilities of X. Upon receipt of the X assets, Y Corporation grants a mortgage thereon to S securing the $1,300,000 note. The stock of Y Corporation might be deposited in escrow as additional collateral security for the note. Y Corporation pays the note out of income generated from its ownership and operation of the former X assets.

The following tax consequences flow from the standard plan under the indicated Code provisions.

(a) No gain is recognized to X Corporation on the distribution of its assets to Y Corporation as liquidating distributions (Section 336).

(b) Y Corporation obtains an immediate $1,300,000 cost basis for the X Corporation stock

when received as dividends, and the 48c less the 70% individual tax leaves 14.4c after taxes for payments by P upon the purchase price.

(Section 1012).[17]

(c) No gain is recognized to Y Corporation upon the receipt of the X assets as liquidating distributions (Section 332).[18]

(d) Y Corporation receives a basis for the X assets equal to its $1,300,000 cost basis for the X stock plus the amount of X Corporation liabilities taken over by Y upon the liquidation of X into Y. Such transfer of Y Corporation's $1,300,000 basis for the X stock to the underlying corporate assets is accomplished through Section 334(b)(2).[19] The basis is allocated among the assets in accordance with relative actual values.[20]

(e) S elects the installment method under Section 453 and reports his gain proportionately as and when he receives payments from Y Corporation on the $1,300,000 note. Section 453 expressly permits reporting of gain on the installment me-

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[17] Treasury Regulation Section 1.1012-1 provides:

"In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash *or other property*." (Emphasis supplied).

It might be argued that the basis of the property in the hands of the purchaser is the purchaser's equity in the property on the theory that the note given by the purchaser does not constitute other property. The Commissioner made such an argument in an analogous situation in *Crane* v. *Commissioner*, 331 U.S. 1 (1947). This Court rejected the Commissioner's position mainly because of the bearing such construction would have on the allowance of deductions for depreciation and adjustments of basis.

[18] Y Corporation would not have any gain upon the liquidation even in the absence of Section 332 since Y Corporation has a cost basis of $1,300,000 for the X Corporation stock so the net value of the X Corporation assets would not exceed this basis.

[19] Section 334(b)(2) is a codification of the holding in *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), affirmed 187 F.2d 718 (1951), Cert. Den. 342 U.S. 847 (1951).

[20] Treasury Regulation Section 1.334-1 (c)(4)(viii).

thod even though no payments are received during the year of sale.

(f) The income generated by Y Corporation's operation of the former X assets is not taxed as a dividend to P (or anyone else) when paid upon the $1,300,000 note. Since the obligor on the note and the owner and operator of the assets are one and the same, no dividend distributions are required.

VI

Difference between instant transaction and standard buyout plan is one of mechanics. Buyout of Clay Brown & Company under standard plan would produce 70-cent after tax dollars the first year.

The instant transaction differs from the standard corporate buyout plan outlined above only in that the purchaser (the Institute) derived income from the underlying assets through a lease of the assets to Fortuna Sawmills, Inc. instead of a direct operation of the business. The difference is one of mechanics. Contrary to the "treasury raid" innuendoes made by the Commissioner, 80% of the profit paid by Fortuna to the Institute in the form of rental would not have been subjected to corporate tax if the Institute had been a taxable entity. Such corporate tax would be diminished through the benefits of basis allocation under Section 334(b)(2) in the following manner.

The $1,300,000 cost basis for the Clay Brown & Company stock exceeded the book net worth of Clay Brown & Company by $680,000.[21] At least $600,000 of

[21] As reviewed in footnote (4), the book net worth of Clay Brown & Company at January 31, 1953 shown on the balance sheet set forth in the Tax Court findings (Tr. 22) was $619,457. The $1,300,000 exceeds this book net worth by a shade over $680,000.

this excess could have been allocated to depreciable and depletable property;[22] with the result that a taxpaying corporate purchaser would have $600,000 of depreciation and depletion deductions more than the deductions which would have been available to Clay Brown & Company upon a continuation of the business by it. The $600,000 additional basis is over and above (not in lieu of) Clay Brown & Company's net book value for plant, equipment and timber in the amount of $570,000, shown on the balance sheet.[23] This $570,000 basis, plus the $600,000 additional basis, makes available $1,170,000 in depreciation and depletion deductions over the remaining useful life of the property which the Institute could apply against the rental paid by Fortuna.

Operation of the business by the Institute would have subjected the profits to corporate income tax as unrelated business income under Section 511 et seq. In turn, the Institute would be entitled to its depreciation deductions. Such $1,170,000 in depreciation and depletion is dormant when the Institute applies its tax

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[22] In basis allocation under Section 334(b)(2), book value is ordinarily allocated to cash and the equivalent of cash such as accounts receivable and inventory so none of the $680,000 would be absorbed by the cash, receivables or inventories shown on the January 31, 1953 balance sheet (Tr. 22). The only non-depreciable asset is the land, and the $80,000 is more than ample to allow for any appreciation which had occurred in the land, leaving the $600,000 for allocation among the building, equipment, facilities, furniture and fixtures, and timber. A more detailed breakdown of the assets than that shown on Tr. 22 is contained in the audited balance sheet at January 31, 1953 (Tr. 280).

[23] The $570,000 figure is the rounded total of the capital assets and timber shown on the January 31, 1953 balance sheet (Tr. 22). In an actual allocation of basis under Section 334(b)(2), the total purchase price plus the total liabilities assumed are allocated among the assets which produces the same net result as shown in the above review.

exemption to the rental received from Fortuna Sawmills, Inc.

Suppose the transaction were handled under the standard corporate buyout plan. How many dollars would be available for payment upon the $1,300,000 note for each dollar of income generated by the underlying corporate assets? The following realistic assumptions are used in the computations: The assets conservately have a depreciable basis of $1,000,000. The remaining useful life of the depreciable assets is 10 years.[24] The earnings are $350,000 a year before depreciation and taxes. The declining balance method of depreciation (1½ times) is used. Based on these assumptions, each dollar generated by the underlying corporate assets would produce the following number of cents after taxes available for payment upon the purchase price: 70¢ the first year, 67¢ the second year, 64¢ the third year, 62¢ the fourth year and 60¢ the fifth year, or composite for the 5-year period of 65¢.[25]

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[24] Revenue Procedure 62-21, 1962-2 Cum. Bull. 418 setting forth guide lines for depreciation specifies a useful life of 10 years for a sawmill and its equipment. There is no salvage value required under guide line lives since the period specified takes depreciation into account. That is, a 10-year useful life is the same as a 9-year useful life with 10% salvage. The guide lines specify 10 years with no salvage, rather than 9 years with 10% salvage.

[25] These figures are computed as follows:

	1st year	2nd year	3rd year	4th year	5th year
1. Earnings before depreciation	350,000	350,000	350,000	350,000	350,000
2. Depreciation	150,000	127,500	108,375	92,120	78,305
3. Taxable income	200,000	222,500	241,625	257,880	271,695
4. Tax - 52%	104,000	115,700	125,645	134,100	141,280

As previously stated, the objective of the Institute-Fortuna Sawmills, Inc. lease arrangement was the production of 72¢ for payment upon the purchase price out of each dollar generated by the assets. Production of 70¢ the first year and a composite of 65¢ for a 5-year period may not equal the 72¢ of the instant plan, but it comes quite close and the difference does not represent any "extraordinary" tax benefits.

Total depreciation of $556,300 was consumed during the five years covered by the above illustration which would leave $443,700 of depreciation available during subsequent years. If a remaining useful life of seven years (rather than ten) could be sustained for the depreciable assets, each dollar generated by the underlying corporate assets would produce 80¢ the first year, 73¢ the second year, 68¢ the third year, 63¢ the fourth year and 60¢ the fifth year, or a composite for the 5-year period of 69¢.[26] Depreciation is not the only method for recouping tax basis without payment of tax thereon. The difference between $1,300,000 purchase price in the illustration and the $1,000,000 allocable to the depreciable assets is not

5. Net income	96,000	106,800	115,980	123,780	130,415
6. Add back depreciation	150,000	127,500	108,375	92,120	78,305
7. Cash income	246,000	234,300	224,355	215,900	208,720
Cents of cash income per dollar generated (ratio between line 7 and line 1)	70.3	67.0	64.1	61.7	59.6

[26] These figures are computed in the same manner as set forth in footnote 25.

lost but is absorbed as the basis for the accounts receivable and inventory. Any reduction in accounts receivable or inventory will produce tax-free dollars. As previously stated, this is all a manifestation of the basic tax principle that a purchaser is entitled to recoup the cost basis for property without payment of tax on the recoupment. Utilization of this basic principle is overlooked when the Institute's tax exemption is utilized. The erroneous inference is created that all income to which the exemption is applied would otherwise be taxable.

VII

Congress has not been dilatory in its surveillance of the tax area encompassed by the standard corporate buyout plan and by transactions of the instant type.

An avenue of possible abuse under the standard buyout plan has been closed through Section 1245 (added to the Code by the Revenue Act of 1962).[27] As related in the standard buyout plan, Corporation Y is entitled under Section 334(b) (2) to step up its basis for the assets to reflect the $1,300,000 purchase price payable by Y for the X stock, without any corresponding gain to X Corporation upon the liquidating distribution of the X assets to Y. In certain instances, the spread between X Corporation's basis for the depreciable assets and the stepped-up basis attainable by Y Corporation may be attributable to the aggresive depreciation policy of X Corporation, rather than any appreciation in value of the assets. Since X

[27] Revenue Act of 1962, Section 13(a); 76 Stat. 960.

Corporation previously enjoyed substantial depreciation deductions, an undue tax advantage might result when Y Corporation obtains ordinary deductions through depreciation of the same assets on the stepped-up basis without any corresponding tax detriment, except the capital gain tax to S. Section 1245 taxes as ordinary income the gain realized upon the sale or other disposition of depreciable property to the extent of depreciation taken after December 31, 1961. Dispositions covered by Section 1245 include liquidating distributions.[28] If X Corporation had taken $300,000 of depreciation after December 31, 1961, Section 1245 would charge Corporation X with $300,000 of ordinary income, and the tax liability resulting therefrom would be one of the obligations taken over by Y Corporation.

Section 1245 will apply to transactions such as the instant one. The triggering event for application of Section 1245 is the liquidating distribution of the assets by the taxpaying acquired corporation, so the tax-exempt status of the distributee does not immunize the transac-

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[28] Section 1245 (a)(1) provides:

"Except as it otherwise provided in this section, if section 1245 property is disposed of during a taxable year beginning after December 31, 1962, the amount by which the lower of—

(A) the recomputed basis of the property tax, or

(B)(i) in the case of a false sale, exchange or involuntary conversion, the amount realized, or

(ii) *in the case of any other disposition, the* fair market value of such property,

exceeds the adjusted basis of such property shall be treated as gained from the sale or exchange of property which is neither capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle. * * *" (Emphasis supplied).

A liquidating distribution constitutes a disposition of property.

tion from Section 1245. Section 1245 represents a scalpel touch applied by Congress to a sensitive tax area under its continuing surveillance. As later pointed out, Congress is well aware that selling stockholders claim capital gain where the payment of the purchase price is dependent upon future income derived from the business.

VIII.

Features peculiar to the Commissioner's "simplified version" account for the complications encountered by him, and for his assertion that the transaction makes no economic sense. The taxpayers present an unbiased simplified version.

In the simplified version of the transaction used by the Commissioner as the basis for his argument, the amounts paid to the transferor stockholder are derived by an individual transferee from the underlying corporate assets through dividend distributions which are then remitted to the transferor (Br. 30-31). In such a transaction each dollar generated by the underlying corporation assets is subjected to the 52% corporate tax, and the 48¢ remainder when taxed to the individual transferee as a dividend (at a 70% rate) leaves only 14.4¢ for payment to the transferor. The Commissioner's assertion that the transaction makes no economic sense is a natural reaction to an arrangement whereunder each dollar generated by the underlying assets produces a mere 14.4¢ after taxes for payment on the purchase price.

The only suggestion made by the Commissioner for alleviating the prohibitive tax cost under his simplified

version is the use of a tax-exempt entity as purchaser and recipient of the dividends (Br. 34). This solution precludes the dividend tax, but leaves each generated dollar subject to the full corporate tax, resulting in 48-cent dollars (assuming a 52% corporate rate). The Commissioner fails to indicate that the dividend difficulties can be avoided through the simple expediency of eliminating the necessity for the dividends,—liquidation of the acquired corporation into a corporate purchaser per the standard corporate buyout plan which permits the corporate purchaser to pay the purchase price directly out of income generated by the underlying assets. Neither does the Commissioner mention that such liquidation would step up the basis for the underlying corporate assets thereby reducing the purchaser's corporate tax through increased depreciation and other deductions.

All bridges between the Commissioner's self-imposed complications and Code-sanctioned solutions are burned by the specification in his key supposition that the stock being transferred is a *minority* interest in a *widely-held* corporation (Br. 30-31). A minority stockholder of a widely-held corporation cannot follow the liquidation route. The facts are that Clay Brown & Company, a *closely-held* corporation, *was* liquidated into the purchaser, and the sums paid to the taxpayers were *not* extracted as dividends.

Taxpayers' frequent reference to liquidation of the acquired corporation into the purchaser should not be interpreted as a contention that liquidation has inde-

pendent capital gain significance, such as may be the case for stock redemptions.[29] Under taxpayers' version of the transaction, liquidation is merely one step of a plan whereby income derived from the underlying corporate assets may be paid upon the purchase price in a manner which makes economic sense and avoids the anomalies encountered by the Commissioner under his divided suppositions.

There is merit in the Commissioner's desire to "close off the transaction after the first step" (Br. 29), if such can be accomplished in a manner which neutralizes the subsequent steps without prejudicing the issues. An unbiased neutralization of the subsequent steps is not accomplished by a version which employs "dividends" as the means of extracting income for payment upon the purchase price. No word in the English language has greater ordinary income connotations than "dividend."

The following is proposed as an appropriate simplified version of the transaction.

> Stockholder S transfers all the stock of Corporation X to Corporation P for an agreed-upon fixed price payable by P over a period of years where (i) the liability of P to pay the fixed price is limited to income generated by the underlying assets (and proceeds from the disposition thereof), and (ii) there is no down payment other than from underlying assets.

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[29] Section 331 assures capital gain treatment in the case of partial or complete liquidations.

IX.

The Commissioner's denial of capital gain is based entirely upon the lack of down payment coupled with the fact that the liability of the Institute to pay the purchase price was limited to income generated by the underlying assets (and proceeds from the disposition thereof). The taxpayers claim that capital gain recognition is not thereby precluded.

A distinction is drawn by the Commissioner between "sales" on the one hand and "transfers with income reserved" on the other hand. According to the Commissioner, the distinction is one of "risk-shifting",—the extent to which the transferor's receipts are dependent upon the future income yield from the property or upon future changes in the value (Br. 52). The Commissioner recognizes that shift in risk is sufficient for capital gain recognition if there has been a substantial down payment, or if there is a personal obligation to pay the purchase price on the part of a solvent entity, even though income generated from the underlying assets is in fact used to make the payments (Br. 53-54). The importance of risk in capital gain determination is no greater than the consequence which may evolve from the risk.

Receipt of a *less* than agreed-upon price for the Clay Brown & Company stock was the only consequence which could evolve from the risk born by the taxpayers attributable to the fact that there was no down payment from independent sources and the fact that liability of the Institute to pay the purchase price was limited to income generated by the underlying assets (and proceeds from the disposition thereof). Why should the

possibility that the transferors may receive less than the agreed upon price preclude a conversion of capital investment to the extent of the amounts actually received? The $936,131.85 received from the Institute is all the taxpayers had to show for the surrender of their Clay Brown & Company stock. The fact that the receipts were less than the agreed upon price makes the conversion of capital investment *more* acute from the taxpayer's viewpoint.

Where persons have *purposely* transferred property for less than the acknowledged value at the time of the transfer, the existence of a sale has never been questioned. In such situations, the problem is how does the transferee account for the bargain portion of his "bargain purchase"? If the purchaser is an employee, the bargain portion is compensation.[30] If the purchaser is a family member, the bargain portion is a gift.[31] Since a conversion of capital investment is not affected by a purposeful transfer at less than the acknowledged value of the property, why should a conversion of capital investment be nullified by the *possibility* that the transferor may receive less than the agreed upon price?

No authorities whatsoever are cited on the pages of the Commissioner's brief where he considers the question "What, then, is the difference between sales and transfers with income reserved?" (Br. 52-59). The decision of this court in *Le Tulle* v. *Scofield*, 308 U.S. 415 (1940), may be pertinent. There the taxpayer was

[30] Treasury Regulation Section 1.61-2(d)(2).

[31] Treasury Regulation Section 1.101-1(e).

attempting to qualify a transaction as a tax-free reorganization. To establish the requisite continuity of interests, the taxpayer argued that certain bonds should be considered as equity because of their terms. This court rejected the contention with the following statements (308 U. S. at 421):

> "We are of opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute."

If there is a difference between a sale and a "transfer with income reserved" it lies in the distinction between payments *for* future income, and payments *from* future income. If the purchase price substantially exceeds the value of the property at the time of transfer, the portion of the purchase price in excess of the value at the time of transfer constitutes a payment *for* future income. On the other hand, if the purchase price is within a reasonable range of the value of the property at the time of transfer, payments received upon the purchase price constitute proceeds from the conversion of capital investment even though payment of the pur-

chase price is *completely* dependent upon future income generated by the property transferred. Such payments are *from income* and not *for* future income. The Commissioner sluffs over this distinction by asserting in a variety of forms that the purchase price, of necessity, will substantially exceed the value of the property at the time of transfer when payment is entirely or even substantially dependent upon future income from the property.

The difference between payment *from* future income and payment *for* future income is illustrated by a comparison of the instant case with *Kolkey* v. *Commissioner*, 254 F.2d 51 (7th Cir. 1958). In *Kolkey*, the taxpayer sold for $4,000,000 on a deferred basis a company worth less than one-half the purchase price. Such a "sale" if allowed to stand would have converted future ordinary income to capital gain. Obviously, the payments were in substantial part *for* future income. Just as obviously, where a realistic purchase price is negotiated for the underlying assets, there is a conversion of capital investment even though the purchase price is payable *from* future income.

X.

Recent indications of Congressional intent confirm the allowace of capital gain treatment where payment of the purchase price is dependent upon future income derived from the property.

Congress has upon two occasions within the last year expressed its intent concerning capital gain qualification for payments dependent upon future income derived from the property transferred, —once through an

amendment to the Code, and once by a refusal to change the law in the manner requested by the Secretary of the Treasury.

Section 483 (added to the Revenue Code by the Revenue Act of 1964, Section 224, 78 Stat. 19) imputes interest upon sales of property even though the agreement between the parties provides for no interest. The purpose and operation of Section 483 are fully set forth in the extract from the Senate Report quoted in the footnote.[32]

Paragraph (d) of Section 483 covers payments indefinite as to time, liability or amount. The Senate Committee Report explains paragraph (d) as follows (S. Rep. No. 830, 88th Cong., 2d Sess., p A466 (3 U.S.C. Cong. & Adm. News (1964):

"Where at the time of the sale or exchange,

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[32] "Under present law, an individual may sell a capital asset on the installment basis without making any specific provisions for interest payments on installments. In such cases, the full difference between the cost or other basis for the property and the sales price usually is treated as capital gain to the seller. The buyer takes as a basis for the property the total sales price paid. * * *

"Your committee agrees with the House that there is no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. * * * In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. At the same time the purchaser can still recoup the amount as a deduction against ordinary income through depreciation deductions. * * *

"The bill solves the problem referred to above by providing that where property is sold on an installment basis and part or all of the payments are due more than 1 year after the date of the sale or exchange—if no interest payments are specified or if 'too low' interest payments are specified then part of each payment due after 6 months is to be treated as interest rather than as part of the sales price."

S. Rep. No. 830, 88th Cong., 2nd Sess., pp A464-A465 (3 U.S.C. Cong. & Adm. News (1964).

> some or all of the payments are indefinite as to their size: *for example where the payments are in part at least dependent upon future income derived from the property,* the 'unstated' interest for purposes of this provision will be determined separately with respect to each indefinite payment as it is received, taking into account the time interval between the sale or exchange and the receipt of the payment. * * *" (Emphasis supplied).

There would be no need for paragraph (d) of Section 483, if the full amount of payments dependent on future income derived from property were taxable as ordinary income due to noncompliance with the sale or exchange prerequisite for capital gains.

The $1,300,000 note evidencing the purchase price for the Clay Brown & Company stock was payable without interest. As an alternative argument in the Tax Court, the Commissioner contended that some portion of the payments received by the taxpayers represented an interest factor taxable as ordinary income. The Tax Court rejected this contention, which was not presented by the Commissioner upon appeal to the Circuit Court. Section 483 applies to transactions of the instant type occurring after the effective date of the amendment, and imputes interest at the annual 4% rate specified by the Commissioner.[33] For example, payments made at the end of the fifth year following such a sale will be considered 20% interest. Since an Act of Congress was required to adopt the alternative contention of the Commissioner, should not the adoption of his main contention likewise await an Act of Congress?

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[33] Treasury Regulation Section 19.3-1 (temp.).

If there is any doubt after enactment of Section 483 concerning Congressional intent in regard to capital gain treatment for payments contingent on future income, the doubt is eliminated through the refusal of Congress to make the change urged by the Secretary of the Treasury in the following extract of his statement on February 6, 1963, before the Committee on Ways and Means of the House of Representatives: [34]

> "*Deferred payments contingent on future income*
>
> "Pursuant to the President's recommendation that changes be affected in the definitional aspects of capital gains taxation, it is proposed that payments on the sale of a capital asset (or payments so treated under present law) which are deferred over more than 5 years and are contingent on future income be treated as ordinary income.
>
> "* * * In the case of contracts for the sale of such assets made after February 6, 1963, where the seller retains a long-term income interest, the proposal would treat as ordinary income, payments contingent on future income from the asset sold, or from the income-producing property underlying the asset sold. * * * For example, the proposal would cover the sale of stock in a corporation where payment is contingent on dividends on the stock or productivity of the corporate assets.
>
> * * * * *
>
> *Example* 1
>
> "S owns all of the stock of M corporation. The stock has an adjusted basis of $75,000 in S's hands. S sells the stock to P for $50,000 cash plus

[34] Hearings before Committee on Ways and Means on H.R. 8363, 88th Cong., 1st Sess., 154 (1963).

> $300,000 payable only out of 75 percent of M corporation's net profits in excess of the first $50,000 of such net profits. Under present law, assuming S would be entitled to cost recovery, he would offset his basis against the downpayment and the first $25,000 of contingent payments and would receive capital gains treatment with respect to all subsequent payments. Under the proposal S would first recover his basis, as under present law, against the downpayment and the first $25,000 contingent payments, but subsequent contingent payments would be treated as ordinary income."

There are striking similarities between the facts of Example 1 and the facts of the instant transaction. In Example 1, S transfers *all* the stock of M Corporation, not a minority interest. This permits the liquidation of M Corporation, thereby precluding the necessity for dividend extractions as the means of applying the net profit upon the purchase price. While Example 1 does not specify the mechanics by which the 75% of profits are paid upon the purchase price, it seems obvious the liquidation route, not the dividend route, is intended.[35]

The $50,000 down payment in Example 1 does not contemplate new money from an independent source, at least not for long. The express statement in Example 1, that the obligation of M Corporation to pay 75% of the profits upon the purchase price does not commence

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[35] If the standard corporate buyout plan were utilized, P would form a new corporation which would carry out the purchase. The formation of a new corporation is not essential, however. P could liquidate M Corporation and carry on the business as a sole proprietorship. P would have no gain upon the liquidation since P has a basis of $350,000 for the M stock, so the value of the assets, less the liabilities, would not exceed such basis.

until the $50,000 down payment has been recouped, makes it immaterial whether the $50,000 was originally taken from M Corporation assets or whether it was temporarily supplied by B, or obtained through a loan on the M assets which would be repaid before commencing payment on the purchase price. Neither is payment of the purchase price under Example 1 backed up by personal liability or other assets since the $300,000 is payable *only* out of 75% of M's net profit.

Example 1 contains all the features cited by the Commissioner for denying capital gain recognition to the taxpayers,—(i) payment of the purchase price entirely dependent upon productivity of the corporate assets, (ii) no commitment of other assets or personal liability, and (iii) no injection of new funds through a substantial down payment (except possibly on a temporary basis).[36] The Secretary of the Treasury did not say there was an ambiguity concerning the law in the Example 1 situations. He unequivocally stated that under present law S would receive capital gain treatment on all payments in excess of basis, and the Secretary requested Congress to *change* the law through adoption of an amendment which would tax all payments to S in excess of basis, as ordinary income.

Congress refused to adopt the proposal for the change in the law illustrated by Example 1. However,

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[36] In citing the lack of a down-payment as grounds for capital gain denial (Br. 56, fn. 30), the Commissioner negates substance to a down-payment to be recouped by the transferee prior to payment of the remaining purchase price. His negation runs contrary to the Secretary of the Treasury's concept of the status of the present law as expressed in example 1.

Congress did not leave S with all of his receipts taxable as capital gain. Section 483 will tax a portion thereof as ordinary income at the annual 4% imputed interest rate. This is a clear indication of Congressional intent that the law should stay as represented by the Secretary of the Treasury in Example 1, subject, however, to the impact of Section 483.

The statement by the Secretary of the Treasury before the Committee on Ways and Means of the House of Representatives contained a second example which reads as follows: [37]

Example 2

"S owns a patent which he purchased from the inventor in 1963 for $100,000. In 1964 S sells the patent to P under a contract providing for payments of $0.20 per unit produced under the patent but no less than $10,000 annually for the 10-year remaining life of the patent. Under the present law, all payments in excess of S's basis would be treated as long-term capital gains (assuming the contract has no fair market value). Under the proposals, a portion of the fixed annual payments of $10,000 would be treated as interest and S would offset his basis against the first $100,000 of both contingent and fixed payments (except to the extent treated as interest). Thereafter, $10,000 per year would be treated as partly ordinary interest income and partly capital gain. The excess over $10,000 in any year would be treated as ordinary income since such excess is contingent on further income."

[37] Hearings before Committee on Ways and Means on H. R. 8363, 88th Cong., 1st Sess. 154 (1963).

Example 2 illustrates the effect of the interest imputation proposal (adopted by Congress in Section 483) and the contingent income proposal (rejected by Congress) upon patent transfers of the type covered by Revenue Ruling 58-353.[38] Example 2 shows how the proposal for interest imputation taxes a portion of the fixed required minimum payments as ordinary income and how the contingent income proposal taxes as ordinary income all the remaining payments based on unit production. By adopting the interest imputation proposal (Section 483), Congress agreed that a portion of the patent payments, both fixed minimum payments and contingent payments based on productivity, should be taxed as ordinary income (to the extent of the imputed interest), but that the balance of the payments, those contingent on future income generated by the patent, as well as fixed minimum payments, should be entitled to capital gain treatment. This refutes the Commissioner's assertions that the cases according capital gain treatment for patent payments contingent upon income generated by the transferee's use of the patent are clearly erroneous (Br. 68). Cases interpreting provisions of the Internal Revenue Code can be erroneous only if the interpretation does not reflect the intentions of Congress. Now, we have definite Congressional indication that the law established in these

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[38] Section 483 (f)(4) expressly excludes the interest imputation application of Section 483 to the sale or exchange of patents under section 1235(a). By limiting the exception from Section 483 treatment to Section 1235 patent transfers, Congress implied that Section 483 would apply to patent transfers of the type covered by Revenue Ruling 58-353. Example 2 portrays a Revenue Ruling 58-353 type patent transfer in that S is not the inventor. Section 1235 primarily applies to inventors (See fn. 13, p. 23).

cases correctly reflect Congressional intent. There can be no stronger indication of Congressional intent than a refusal to change the law where both the present law and the proposed change are clearly presented to Congress.

XI

Congressional approval of capital gain treatment for patent payments contingent upon future income refutes the Commissioner's conclusions based on certain oil, gas and mineral cases.

The Commissioner relies heavily upon certain oil, gas and mineral cases which he believes stand for the proposition that capital gain treatment is denied where payment of the consideration is dependent upon income derived through exploitation of the property by the transferee (Br. 44-47). It is recognized by the Commissioner that the conclusions drawn by him from the oil, gas and mineral cases cannot stand side by side with the holdings in the patent cases covered by Revenue Ruling 58-353 which unequivocally accord capital gain treatment for patent transfers even though payment is based on income derived through the transferee's use of the patent (Br. 62). According to the Commissioner, only one of the two can prevail, and the Commissioner nominates the oil, gas and mineral cases as the deserving survivors (Br. 68).

If an impasse actually exists between the oil, gas and mineral cases cited by the Commissioner and the patent cases covered by Revenue Ruling 58-353, the indications of Congressional intent related under the preceding heading tip the scales in favor of the patent

cases. However, no impasse actually exists because the oil, gas and mineral cases do not support the Commissioner's conclusion.

Only one case cited by the Commissioner involves capital gain. In *Burnet* v. *Harmel,* 287 U.S. 103 (1932), the owner in fee of Texas oil lands granted oil and gas leases for as long as oil or gas should be produced from the lands in return for bonus payments and stipulated royalties measured by the production of oil and gas by the lessee. The taxpayer in *Burnet* v. *Harmel,* recognized that there would be no possibility of capital gain qualification if title to the oil and gas passed to the lessee only upon severence from the leasehold. His capital gain assertion rested on Texas law whereunder oil and gas leases operated immediately upon execution to pass the title to the oil and gas in place to the lessee. This Court held that the peculiarities of Texas law did not control the tax consequences, and that the interest passed to the lessee was more in the nature of a privilege than a transfer of a capital asset. The Commissioner fails to explain exactly what application this holding has to the instant situation.

Of the oil, gas and mineral cases cited by the Commissioner involving percentage depletion, only one concerns the sale of corporate stock, *Helvering* v. *O'Donnell,* 303 U.S. 370 (1938). In this case, the taxpayers sold stock of a corporation owning oil and gas property. The consideration for the stock was one third of the net profit derived from the exploitation of the underlying oil and gas properties. This Court rejected the taxpayer's claim

for percentage depletion. Just such a situation is capsulized in the following extract from the previously-quoted statement by the Secretary of Treasury to the House Ways and Means Committee concerning the proposal for taxing deferred payments contingent on future income (Point X, p. 44):

> "* * * For example, the proposal would cover the sale of the stock in a corporation where payment is contingent on * * * productivity of the corporate assets."

The Commissioner contends that the *O'Donnell* case has in some way been modified by subsequent depletion cases to an extent which would require denial of capital gain recognition under the facts of *O'Donnell* (Br. 47-48 fn. 26). If this is true, why was it necessary for the Secretary of the Treasury to include the above example in his proposal for a change in the law? A sale of stock in a corporation where payment is contingent on productivity of the corporate assets represents the essence of the fact situation in *O'Donnell*. Counsel for the taxpayers have carefully reviewed the cases cited by the Commissioner and find nothing therein which negates capital gain recognition upon the sale of stock in a corporation for a price payable out of income derived from exploitation of the underlying oil and gas properties.

XII.

In transactions where arms-length bargaining is impossible, only the excessive portion of the consideration is taxed as ordinary income, not the full consideration.

As reviewed under Point IV, capital gain is recognized upon a transfer of property by an individual to his own corporation provided the transferor does not run afoul of Section 1239 by owning more than 80% of the stock of the transferee corporation. Arms-length negotiation is not expected between an individual and a corporation in which he owns 80% of the stock (or even 51%). Yet, Section 1239 recognizes that capital gain should be allowed the transferor in such transactions even for depreciable property. The Commissioner and the Courts closely scrutinize these transactions to assure that a proper relationship is maintained between value and purchase price. The situation is well expressed by the Tax Court in *Roy J. Champayne*, 26 T.C. 634 (1956), one of the cases approved by the Commissioner in Revenue Ruling 58-353, which accords capital gain treatment (under the general Code provisions here involved) for transfer of a patent to the transferor's controlled corporation (26 T.C. at 645):

> "Respondent's arguments have been carefully considered together with the entire record. It is recognized that in a situation such as the one before us, where the principal stockholder of a corporation also owns a patent and receives payments out of the sales of the patented article, it is possible for a transaction involving such payments to give

rise to suspicion. But, as has been said before, tax issues cannot be decided on suspicion; they must be decided on the facts of each particular case, taking into account the burden of proof, if any, which may be upon the taxpayer or upon the respondent, as the case may be."

Roy J. Champayne further indicates the penalty to be assessed if the consideration is too high. The excessive portion of the consideration is taxed as ordinary income, not all the consideration. This fitting of the penalty to the alleged rule infraction contrasts with the Commissioner's assertion in the instant case that all the taxpayers' receipts from the Institute (in excess of basis for the stock) should be taxed as ordinary income, not merely the portion thereof which the Commissioner believes may exceed the value of the Clay Brown & Company stock at the time of transfer. Actually, the Commissioner has not stated that he believes the $1,300,000 (much less the amount actually received) exceeds the value of the Clay Brown & Company stock. Rather, he relies entirely upon innuendoes derived from his simplified version of the transaction having no relationship to the actual facts. Even if his innuendoes should be correct, it is one thing to nullify the illegal play (tax the excess as ordinary income as did the Court in *Roy J. Champayne*), but quite another thing to forfeit the whole ball game. The sums received from the Institute are all the taxpayers ever obtained for the Clay Brown & Company stock or the underlying corporation assets. Taxation of all these receipts as ordinary income leaves them with very little to show for their conversion of capital investment.

XIII.

Impact of the Commissioner's position extends far beyond the type of transaction here presented.

For every transaction of the type here involved, there are many corporate buyouts under the standard plan utilizing a thinly financed purchasing corporation where, as a practical matter, the purchase price is payable only out of income generated by the underlying assets and the assets themselves, whether or not such limitation of liability is expressly spelled out in the purchase agreements. Similar situations occur in purchases of real property with no down payment under the laws of most states which prohibit deficiency judgments thereby rendering the purchase price payable only from the asset itself. A label, sometimes attached to such transactions, is "shoestring" or "bootstrap" purchase.[39]

By denying capital gain unless there is a substantial down payment from independent sources or personal liability by a purchaser with adequate finances, the Commissioner is laying down specifications for the type of purchaser who is capable of according capital gain treatment to a seller. The Commissioner's specifications favor those possessing financial affluence,—the "haves" in contrast to the "have-nots". In the past, shoestring or bootstrap purchases have been a primary method whereby "have-nots" become "haves". The "haves" already enjoy certain advantages in the market place by the very nature of their "having". The Commissioner's

[39] Contrary to the inferences of the Commissioner in his petition, a grossly inflated purchase price is not a necessary attribute of a "bootstrap" purchase.

specifications accord them a substantial additional advantage of being the only ones who can assure capital gain to a prospective seller.

The position of the Commissioner militates against *any* deferred-payment sale because a seller runs a risk as to whether the size of the down payment or financial affluence of the purchaser falls within or beyond the shadowy boundary line. The only sure solution would be an all cash sale, or a disposition through the tax-free reorganization provisions of the Code. Use of the reorganization provisions permits a transferor to readily convert his investment into cash only if the security is a marketable security. Larger corporations are more inclined to have marketable securities than smaller organizations. It seems rather anomalous to have anti-trust laws which discourage concentration of business in a few hands through the merger route or otherwise, and at the same time have a tax policy which definitely favors acquisitions by financially affluent purchasers and corporations having marketable securities. Considerable romance will depart from the American economic scene if the "have-nots" cannot compete with the "haves" for the purchase of businesses,—whether the objective of the "have-not" is to provide funds for cancer research, or amass a personal fortune.

Congress is well aware of shoestring or bootstrap purchases, and all their ramifications. Within the past few years, the ground rules for such purchases have been affected by the adoption of Section 1245 (the depreciation recapture provision applicable to liquidating distributions of depreciable property as well as to other dis-

positions), and Section 483 (interest imputation provision). As related above (Point X), Congress flatly declined to adopt the proposal made by the Secretary of the Treasury that capital gain be denied deferred payments dependent upon income generated by the asset transferred. In short, Congress was unwilling to sound a death knell for bootstrap purchases, although it changed certain ground rules applicable thereto. Perhaps such a refusal by Congress is attributable to its awareness of the economic and social implications, not mere caprice.

XIV

The contention by the Commissioner in this Court that the transaction is a "transfer with income reserved" is not consistent with the position he has taken in related cases and requires a consideration of matters not raised by the issues presented in the lower Courts.

The Commissioner argues that the transaction in the instant case is a "transfer with income reserved." (Br. 52). He contends that the taxpayers retained the benefits of future income which is fatal to their claim of capital gain. However, at the same time, the Commissioner makes it clear that he has, in related cases, contended that the rental deduction due the operating company (in this case Fortuna Sawmills, Inc.) should be denied. If such future income is really beneficially owned by the sellers, then it certainly is not the income of the operating company and there need be no contention that a deduction from such income for rental should be disallowed (Br. 25, fn. 14).

The Commissioner seeks support for his theory in

the cases involving transfer of interests in oil, gas and mineral rights. However, one of the principal cases upon which the Commissioner relies makes it extremely clear that if the income is in fact reserved by the transferor, the transferee has no taxable income with regard to such future income. *Thomas* v. *Perkins*, 301 U.S. 655 (1937).

The theory of the Commissioner is novel. More important, it is entirely different from the theory upon which the Commissioner relied in the lower Courts. Admittedly, this new theory, if sustained in this Court, requires the case to be remanded to the Tax Court for additional testimony with regard to the myriad of collateral issues which it raises (Br. 71-77). Such proofs were available had the issue been joined on the Commissioner's present theory at the time of the trial in the Tax Court. However, such proofs were unnecessary because the Commissioner argued that there was, in effect, no transfer made by the taxpayers (R. 58).

It is submitted that the Commissioner substantially departed from the original theory upon which the case was tried contrary to the rule set forth by this Court in *Helvering* v. *Wood*, 309 U.S. 344 (1944); *Helvering* v. *Salvage*, 297 U.S. 106 (1936); and *Burnet* v. *Commonwealth Improvement Co.*, 287 U.S. 415 (1932).

CONCLUSION

For the reasons stated, the judgments of the Court of Appeals should be affirmed.

Respectfully submitted.

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